

# **Legislative Audit Division**

**State of Montana**



**Report to the Legislature**

**November 2000**

## **Performance Audit Report**

### **Microbusiness Finance Program**

**Economic Development Division  
Department of Commerce**

**Our review of the Microbusiness Finance Program identified several concerns with the program. These include:**

- < High loan delinquency rates and potential for significant losses.**
- < Loan write-offs are generally understated.**
- < The program is not financially self-sustaining as intended by the legislature.**

**This report contains a recommendation to the legislature to determine the future of the program. It also contains recommendations to improve program operations should the legislature decide to continue with the program.**

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Members of the performance audit staff hold degrees in disciplines appropriate to the audit process. Areas of expertise include business and public administration, statistics, economics, accounting, logistics, computer science, and engineering.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

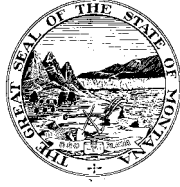
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November 2000

The Legislative Audit Committee  
of the Montana State Legislature

We conducted a performance audit of the Microbusiness Finance Program at the Department of Commerce. The review examined the status of the program's loan portfolio and the outcomes of program activities. The audit also determined whether the program is meeting legislative intent, if the organizational structure provides for efficient program operations, and if alternatives exist for making microloans to businesses.

This report contains several recommendations related to program operations. One recommendation suggests the legislature determine the future of the program. Other recommendations discuss steps that should be taken to improve program operations.

We appreciate the cooperation of the department and local officials during the audit. The department's response is at the end of the report.

Respectfully submitted,

Scott A. Seacat  
Legislative Auditor



# **Legislative Audit Division**

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## **Performance Audit**

# **Microbusiness Finance Program**

**Economic Development Division**

**Department of Commerce**

Members of the audit staff involved in this audit were Joe Murray and Mary Zednick.



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## **Appointed and Administrative Officials**

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### **Department of Commerce**

Dr. Peter S. Blouke, Director  
Andy Poole, Deputy Director  
Gary Morehouse, Finance Programs Manager  
Robyn Hampton, Microbusiness Program Officer

### **Microbusiness Advisory Council**

Billie Lee, Chair  
Duane Kurokawa, Vice Chair

### **Legislative Panel Members (Microbusiness Advisory Council)**

Senator Dale Berry  
Representative Steven Gallus  
Representative Joe McKenney

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### Introduction

The Legislative Audit Committee requested a performance audit of the Microbusiness Finance Program administered by the Department of Commerce. The Montana Legislature created the program in 1991 through passage of the Microbusiness Development Act (Title 17, chapter 6, MCA). The legislature approved an initial appropriation of \$3.25 million from the state's Coal Tax Trust Fund and an additional \$3.25 million from the trust fund in 1995 to make loans to microbusinesses. Microbusinesses are defined as those having fewer than 10 employees and less than \$500,000 in annual gross revenues.

According to the Microbusiness Development Act's 1991 statement of intent, the program:

"Is intended to provide...small loans for economically sound and feasible microbusiness projects that because of the high costs and diseconomies of scale of small lending or unconventional collateral are unlikely to receive financing from conventional public or private sources."

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### Loan Portfolio Is at Risk

During the audit, we reviewed the status of the loan portfolio for the Microbusiness Finance Program. We noted the loan portfolio is at risk. Several conclusions were made related to the program's loan portfolio.

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#### **Conclusion #1: The overall Montana Microloan portfolio has a high delinquency rate and potential for significant loan losses**

Delinquency rates are one way to measure the percentage of a loan portfolio at risk. They are calculated by comparing the outstanding balance of loans with past due payments to the outstanding balance of the entire portfolio. Aging reports for the quarter ending March 31, 2000 showed the microloan portfolios for most local MBDCs had high levels of delinquent loans. Six of the nine funded local MBDCs have delinquent rates over 20 percent and one was over 45 percent. The statewide loan delinquency rate was 20 percent. For most MBDCs there was a general trend for loans with payments one to thirty days late to become delinquent (over 30 days late).

Our review of microloan files found loans that were rewritten one or more times by local MBDC staff. Documentation in loan files indicated loans were often not rewritten because of changes in business

## Report Summary

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status but were rewritten to change a loan's past due status. This gives the loan portfolio the appearance that it is stronger than it really is. Therefore, the program's overall delinquency rate would be higher if some loans had not been rewritten.

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**Conclusion #2: The department reports that cumulative microloan write-offs are under eight percent. However, the amount written off is generally understated compared to what actually exists because doubtful loans are often kept on the books**

Once delinquent loans become 90 days or more past due, collection of the loan is doubtful. When this occurs loans should be "written-off" or removed from the loan portfolio because they are no longer earning income. We believe the actual loan loss may be higher because some local MBDCs are hesitant to write off problems loans. An indication the loan loss could be higher would be a recent write-off of six microloans totaling \$128,000 at one MBDC. This was 32 percent of the dollar value of its loan portfolio.

Department records indicate this is a common scenario for most local MBDCs around the state. We found the total dollar value of loans 90 days or more past due was approximately \$405,000. This is more than half the dollar value of the program's delinquent loans and just under 12 percent of the current loan balance. In addition, there is an outstanding balance of another \$143,000 which could become 90 days past due because borrowers have not made their last two payments.

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**Conclusion #3: Variances exist between MBDCs in the number of loans made, and the number of loans has dropped in some areas during the last two years**

The total number of loans made since program inception varies widely from region-to-region. Numbers range from 10 loans in Colstrip to 110 loans in Helena. We also noted some local MBDCs have made very few loans in the last two years of the program. For example, one MBDC made two loans in calendar year 1998 and one loan in calendar year 1999.

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**Conclusion #4: Most MBDCs are not financially self-sustaining, and it is unlikely they will be as intended by the legislature**

Local MBDCs need to be located within a financially sound "umbrella" organization that can subsidize the operating costs of the MBDC. Financial information reported to the department by the MBDCs for fiscal year 1999-00 shows a total statewide net loss (expenses exceeding revenues) for all the MBDCs was \$342,921. Only one of the active MBDCs showed a positive change in net assets.

The umbrella organization covers the losses experienced by the MBDC, not the State of Montana. The average amount these organizations

spend to subsidize operations at each MBDC is \$31,000 per year. Two local MBDCs (Bozeman and Glendive) chose to leave the program because the entities where they were located no longer wanted to risk the net assets of their organizations on additional loan losses.

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### **Conclusion #5: There are weaknesses with lending procedures followed by some local MBDC lending staff**

We evaluated the lending procedures used by lending staff at the local MBDCs. Our review identified several weaknesses with the local programs' lending procedures. Examples of weakness found included:

- < Business plans were not always obtained or lacked sufficient detail to allow some MBDCs to evaluate a new business proposal.
- < Financial/credit analysis of microloan proposals was limited or nonexistent at some MBDCs.
- < Financial information was not always obtained when loans were made.
- < Liens were not always filed on collateral.
- < Some MBDCs made loans to applicants with poor credit histories including bankruptcies and unpaid collections.
- < Most MBDCs were not actively managing their loan portfolios.

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### **The Legislature Should Determine the Program's Future**

Our audit noted the program has a weak loan portfolio, most MBDCs are not financially self-sustaining, loan activity is dropping in some areas, and the program has difficulty maintaining/attracting qualified staff. It is not clear whether the program has performed at a level that is acceptable to the Legislature. Based on criteria developed by the National Community Capital Association, the program meets the conditions requiring a determination of its future. The legislature should determine the future of the Microbusiness Finance Program.

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### **How Could Program Operations Be Improved?**

We identified several steps that should be taken to improve program operations. These are discussed below.

## Report Summary

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### **MBDC Staff Have Limited Training**

The high delinquency rates and problems with the lending procedures followed by local MBDC staff indicate there is a lack of understanding of proper lending procedures among the MBDCs. Many MBDC staff believe bad loans were made because lending staff was not properly trained and due to high rates of staff turnover. The department should make additional resources available to MBDCs to provide training to staff. In addition, they should require MBDC lending staff to completed a specific number of training hours.

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### **DOC Should Establish Minimum Qualifications of MBDC Staff**

Due to high staff turnover and MBDCs hiring staff with little or no lending experience, program officials said they would like to establish minimum qualifications that lending staff must meet. At the present time the department does not specify qualifications for MBDC lending. The department has not established clear criteria to evaluate whether MBDC staff have the ability to administer microloan funds. The department should establish minimum qualifications for MBDC lending staff and evaluate whether MBDCs are hiring staff meeting these qualifications as part of their on-site review process.

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### **Lending Policies and Procedures are Vague**

Information from the Colorado Graduate School of Banking indicates lending policy directly impacts the effectiveness of the lending process and establishes the framework for lending. During our review, we noted MBDC lending policies are not clear. The department should review and approve local MBDC lending policies and procedures. If necessary, they should provide sample policies and procedures to MBDCs describing the proper lending process.

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### **Some Microloans Did Not Comply with State Law**

We found some local MBDC staff made loans that did not comply with the requirements of the Microbusiness Development Act. These included eleven loans that exceeded the \$35,000 limit established by state law. Based on interviews with local MBDC staff, this occurred because staff financed loan fees into the loan. Upon being notified of this issue, the department notified all local MBDCs the \$35,000 limit is not to be exceeded for any reason.

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### **System Needed to Measure Outcomes**

The department has approximately \$5 million contracted with local MBDCs for the purpose of making microloans. Over \$3 million is loaned to businesses. At the present time neither the department nor the local MBDCs know for sure how many businesses financed through the Microbusiness Finance Program are still operating. The department does not have a system in place that allows them to evaluate the outcomes of the program and whether expectations of the Microbusiness Development Act are being met.

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### **Consultant Reviewed Program in 1994**

In 1994, a private consulting firm hired by the department to review the program determined the majority of businesses receiving loans were already in operation. Most businesses also said they would not have been able to stay in business without the loan proceeds. The consultant also found that about 75 percent of microbusinesses cater mainly to residents and businesses in their immediate area. Therefore, they make a limited contribution to statewide or local economic growth.

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### **Accuracy of Jobs Created/Retained Questionable**

The program tracks the number of jobs created and retained. We evaluated the department's process for compiling this data. Based on this review, we identified weaknesses in the process used to compile this information which raises questions as to the accuracy of this data. We found the program generally takes credit for jobs created or retained even though other programs also played a role in financing the business.

Department records indicate that since program inception, the program has created 730 new jobs in the state and retained over 560 existing jobs. The department relies on estimates borrowers provide to the local MBDCs when loan documents are signed. Limited verification takes place to ensure the accuracy of the information provided. We also noted examples where business ventures were unsuccessful and borrowers obtained other employment so they could pay off the loan. Department records are not updated to account for these situations so the program continues to report jobs created and retained that no longer exist.

The department should develop outcome measurements for the Microbusiness Finance Program. It also needs to establish a system to collect information and measure program outcomes.



## **Report Summary**

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# Chapter I - Introduction

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## **Introduction**

The Legislative Audit Committee requested a performance audit of the Microbusiness Finance Program administered by the Department of Commerce. The Montana Legislature created the program in 1991 through passage of the Microbusiness Development Act (Title 17, chapter 6, MCA). The legislature approved an initial appropriation of \$3.25 million from the state's Coal Tax Trust Fund and an additional \$3.25 million from the trust fund in 1995 to make loans to microbusinesses.

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## **Audit Objectives**

We conducted a preliminary review of the program to gain an understanding of operations and develop our audit objectives. In addition to providing the legislature with background information about the status of the program, we wanted to answer the following questions:

1. What is the status of the loan portfolio for the Microbusiness Finance Program?
2. Does the current program meet legislative intent and does the organizational structure of the program provide for efficient program operations? Do alternatives exist for making microloans to businesses?
3. What have been the outcomes of the Microbusiness Finance Program?

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## **Audit Scope and Methodology**

To gain an understanding of how the Department of Commerce administers the Microbusiness Finance Program, we interviewed department management and staff. We reviewed historical data compiled by the department related to program activities since program inception. Information included total number of loans made, dollars loaned, cumulative loan write-offs, and average loan size. We obtained information regarding loans created and jobs retained. We reviewed Microbusiness Advisory Council meeting minutes, state laws, administrative rules, department policies and files, and budget documents. We attended a Microbusiness Advisory Council meeting. A 1994 study of the program completed by a private consulting firm was also reviewed.

## Chapter I - Introduction

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We examined the process for selecting and certifying Microbusiness Development Corporations (MBDC). We reviewed selection procedures, responses to Request-for-Proposals, and contracts between the department and the MBDCs. We visited each certified MBDC in the state.

We analyzed quarterly reports submitted by MBDCs to the department. These reports included information related to loan delinquencies, the number of loans made, original loan balance, and current loan balance. We also reviewed quarterly financial statements submitted by the MBDCs. This data allowed us to evaluate the financial condition of each MBDC operating in the state. We discussed this information with MBDC and department officials.

We analyzed the lending procedures followed by each MBDC. This was done by reviewing written lending policies and procedures for each MBDC. We also reviewed 53 microloan files to determine the actual lending process followed. This review verified whether loan documentation, such as loan applications, loan agreements, and security agreements, was completed. It also allowed us to review the extent of credit analysis completed on loan proposals and procedures followed by MBDC staff to manage their loan portfolios. We interviewed MBDC personnel regarding their lending process, procedures to manage their loan portfolio, and questions or concerns identified during our loan file reviews.

We obtained criteria for this audit from a variety of sources. We used the department's Microloan Fund Management manual that discusses the principles and strategies for managing microloans. We obtained information from the Corporation for Enterprise Development and the Aspen Institute which provided comparative data on other microenterprise programs around the country. The National Community Capital Association (NCCA) established guidelines on administering community development loan programs. Information from NCCA was used in our assessment of how microloan services should be provided. We also used information from the Colorado Graduate School of Banking and the U. S. Small Business Administration. The Colorado Graduate School of Banking provides

## Chapter I - Introduction

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graduate level study for bank officers wanting to obtain a broader understanding of major banking functions. Additionally, officials from the Montana Bankers Association and the Department of Commerce's Banking and Financial Institution Division were interviewed.

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### **Compliance**

As part of our audit, we reviewed compliance with state laws and administrative rules. Some instances of noncompliance were identified regarding loans made by the MBDCs. We found loans were made to microbusinesses that exceeded the limits set in state law. This issue is addressed in Chapter V.

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### **Management Memorandum**

We sent a management memorandum which questioned whether state law allows loan fees and loan loss reserve fees to be financed into microloans. Department management responded by saying they may seek legislation to clarify this issue.

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### **Report Organization**

The remainder of this report is organized as follows:

- < Chapter II – provides background information on the Microbusiness Finance Program.
- < Chapter III – presents information related to the risk of loan loss.
- < Chapter IV – discusses the need for the legislature to determine the future of the program.
- < Chapter V – provides a discussion on the steps needed to improve program operations.
- < Chapter VI – discusses the need to measure program outcomes.



## Chapter II - Background

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### Introduction

The Microbusiness Finance Program makes loans of up to \$35,000 to small businesses that meet certain criteria. Businesses may use loan proceeds to expand their operations or get started. This chapter provides background information regarding the program.

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### Program Creation

According to the Department of Commerce, 80 percent of businesses in Montana have fewer than 10 employees and less than \$500,000 in annual gross revenues. The legislature believed lending programs were needed to encourage the creation, development, and financing of these kinds of businesses (microbusiness). Therefore, the 1991 Montana Legislature created the Microbusiness Finance Program through passage of the Microbusiness Development Act, Title 17, chapter 6, MCA. According to the act's 1991 statement of intent, the program:

“Is intended to provide . . . small loans for economically sound and feasible microbusiness projects that because of the high costs and diseconomies of scale of small lending or unconventional collateral are unlikely to receive financing from conventional public or private sources.”

The legislature approved an initial appropriation for the program of \$3.25 million from the Coal Tax Trust Fund. In 1995, the legislature appropriated an additional \$3.25 million to the program.

Based on our review of the Microbusiness Development Act and interviews with department officials, the legislature has a number of expectations for the Microbusiness Finance Program. These included:

- < Fostering economic development.
- < Creating jobs and personal earnings for Montana residents.
- < Providing a funding mechanism for small businesses that have limited access to conventional financing.
- < Providing entrepreneurial training to small business.
- < Providing opportunities to women and low-income persons.

## **Chapter II - Background**

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### **Program Administration**

The Microbusiness Finance Program is administered by three types of entities. Certified Microbusiness Development Corporations make loans to businesses at the local level. The Department of Commerce is responsible for program oversight on a statewide level. The department provides the money (through development loans) to the Microbusiness Development Corporations who make loans to local businesses. The third entity, the Microbusiness Advisory Council, advises the department regarding overall program operations. The following sections discuss the role each entity plays in administering the program.

### **Microbusiness Development Corporations**

Microbusiness Development Corporations (MBDC) are local nonprofit entities that provide training, technical assistance, and loans to microbusinesses for the start-up or expansion of qualified microbusinesses. MBDCs are part of larger “umbrella entities,” such as Human Resource Development Councils or local economic development agencies. Each MBDC is responsible for providing program services to several counties within their region. The process for certification and selection of local MBDCs is open and competitive to all interested communities and organizations. Once selected, the department and MBDCs enter into a contract specifying conditions MBDCs must meet to receive development loan funds.

There have been as many as 12 MBDCs operating in the state. Currently, ten MBDCs are operating and located in Billings, Butte, Colstrip, Great Falls, Havre, Helena, Kalispell, Lewistown, Missoula and Wolf Point. The majority of MBDCs have one loan officer who is responsible for making microloans to businesses and providing technical assistance to businesses once the loan is made. Some MBDCs use part-time or contracted employees to handle program operations. Loan officers are often in charge of other loan programs administered by the entity where the MBDC is located.

### **Development Loans**

Development loans are funds loaned by the Department of Commerce from the Coal Tax Trust Fund to MBDCs for the purpose of making microbusiness loans. One major contract requirement MBDCs must meet is obtaining matching funds in a ratio of \$1 (matching funds) to \$6 (development loan funds) before any development loan funds are provided.

Development loan interest rates are set by the department based on an estimate of its administrative costs. Some current contracts charge two interest rates to MBDCs depending on whether development loan funds have been loaned out to microbusinesses. For funds loaned to microbusinesses, the interest rate paid to the department is 2.50 percent. For development funds not loaned out the interest rate is 3.25 percent. This was done to encourage MBDCs to make microbusiness loans. Because of the difficulty in administering two separate interest rates and the department's belief this practice encouraged MBDCs to make bad microloans, a single interest rate of 2.75 percent is now charged. This change is being made as contracts are renewed or new contracts are made.

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### **How Much is Currently Loaned to MBDCs?**

A total of \$6.50 million was appropriated to the program. At the end of fiscal year 1999-00, approximately \$5 million was under contract between the department and the MBDCs. The remainder was not loaned to MBDCs and reverted back to the Coal Tax Trust Fund at fiscal year-end. The following table shows the amount currently under contract with each MBDC.



**Table 1**  
**Balance of Development Loan**  
(June 30, 2000)

<u>Region</u>	<u>MBDC</u>	<u>Amount</u>
Region I	Kalispell	\$ 499,148
Region II	Missoula	790,000
Region III	Butte	327,226
Region IV	Great Falls	419,452
Region V	Helena	378,713
Region VI	Bozeman	113,686 *
Region VII	Havre	1,150,852
Region VIII	Lewistown	0
Region IX	Billings	498,000
Region X	Wolf Point	630,000
Region XI	Glendive	9,175 *
Region XII	Colstrip	<u>250,000</u>
Total		\$5,066,252

\* No longer participating in program; repaying development loan.

**Source: Compiled by the Legislative Audit Division from department records.**

Lewistown is a certified MBDC but elected to pay back its development loan to the department; they are an “unfunded” MBDC. An MBDC has never defaulted on a development loan from the state.

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### Department of Commerce

Section 17-6-406, MCA, delegates responsibility for administering the Microbusiness Finance Program to the Department of Commerce (DOC). The program is located within the department’s Economic Development Division. DOC program administration responsibilities include:

- < Establishing criteria and procedures for selecting and certifying Microbusiness Development Corporations.

- < Establishing criteria and procedures to be followed by MBDCs in administering development loan funds.
- < Determining interest rates, and terms and conditions of development loans made to MBDCs.
- < Determining nonperformance and declaring default in the administration of development loans.
- < Establishing criteria for satisfactory performance in development loan administration to determine eligibility for renewal.
- < Determining maximum/minimum interest rates that may be charged by MBDCs on microbusiness loans.
- < Dividing the state into not more than 12 multi-county service regions.

The department is authorized three FTEs to administer the program. These FTEs include a Microbusiness Program Officer, a Technical Assistance Officer, and an Administrative Assistant. The program officer is responsible for managing the program. This includes overseeing loan agreements between the department and MBDCs, monitoring the impact of the program, conducting MBDC reviews, and compiling statewide microloan data. The program officer also serves as administrative support for the Microbusiness Advisory Council. The Technical Assistance Officer is funded through a U. S. Small Business Administration grant and provides basic business training to microbusiness owners. Training is provided using distant learning technology such as video, audio conferencing, and the Internet to make training available around the state. The program's Administrative Assistant is responsible for all administrative duties for the program.

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### Microbusiness Advisory Council

Section 17-6-411, MCA, established the Microbusiness Advisory Council. The council is a 13-member committee that advises DOC regarding the operation, maintenance, and policies of the Microbusiness Finance Program. Members are appointed by the governor and serve four-year terms. Statute requires at least three members be representatives of certified community lead organizations (such as an economic development agency), at least two members represent

## Chapter II - Background

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communities of less than 15,000, at least three members be owners of microbusinesses, and at least two members have expertise in administering loan funds. There is also a four-member legislative consulting panel consisting of two representatives appointed by the Speaker of the House and two senators appointed by the Senate Committee on Committees. The consulting panel participates in deliberations of the advisory council and advises them regarding program operations but may not vote on any motion before the council. State law requires the council to meet at least once each quarter.

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### Microbusiness Loans

MBDCs can make loans of up to \$35,000 to qualified businesses for working capital, equipment, and other fixed assets. Applicants are generally required to prepare a business plan to demonstrate the feasibility of the business idea, the ability of the business to generate sufficient cash flow to repay the loan, and provide income for the owner. Terms and conditions of each loan vary according to the needs of the business and the useful life of the equipment or assets being acquired. Since the intent of the program is to finance business projects that are not otherwise able to obtain financing from other sources such as their local bank, interest rates charged by MBDCs are generally higher than bank rates.

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### The Lending Process

Applicants are required to provide certain information to the MBDC loan officer for review. Information that should be provided includes business plans, personal and/or business financial statements, tax returns, and a loan application. The loan officer is to review the information to make a preliminary decision on whether the loan should be made. The review process includes assessing the general nature of the business, the ability of the loan applicant to run a business, and the credit history of the borrower. Additionally, MBDC loan officers should review the feasibility of the business proposal, analyze the financial statements, review historical or projected business cash flow, and assess potential collateral.

Every MBDC has a loan committee made up of various individuals from the community. The committee often includes local bankers and business people. Once a loan officer makes a preliminary decision, the proposal is discussed with the committee. When a decision is made to

make a loan, the applicant signs the necessary documents such as a loan agreement and security agreement. MBDCs will generally not provide funds directly to borrowers. Instead, the MBDCs pay vendors once receipts are provided indicating a purchase was made in compliance with the loan agreement.

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### Microbusiness Loan Activity

As microloans are paid back, those funds are available to be loaned to other businesses. Table 2 provides information regarding microbusiness loan activity since program inception.

**Table 2**  
**Microbusiness Loan Activity**  
(Program Inception through June 30, 2000)

Microbusiness Loans Made	673
Microbusiness Dollars Loaned	\$10,423,617
Microbusiness Loans Repaid	315
Dollar Value of Loans Repaid	\$ 3,881,556
Amount of Loans Written-off	\$ 752,881
Average Loan Size	\$ 15,488

**Source: Compiled by the Legislative Audit Division from department records.**

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### Loan Activity by County

Each MBDC provides services to several counties in their region. The highest loan activity is generally located in the county where the MBDC is located. Most counties have businesses that received at least one microloan. However, there are a few counties that have had no microloan activity. The following state map illustrates the number of microloans made in each county since program inception through March 31, 2000.

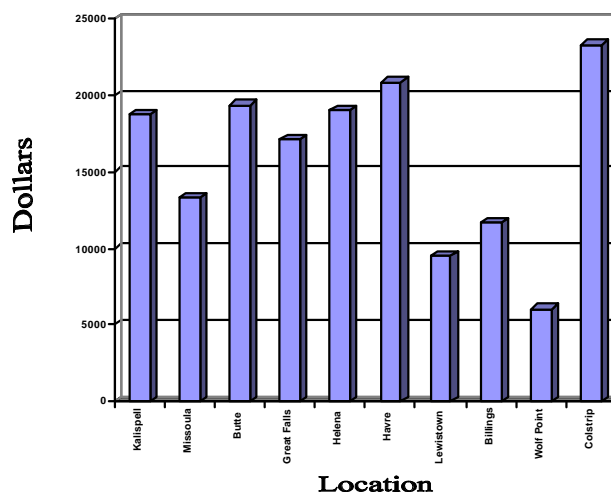
**Source:** Compiled by the Legislative Audit Division from department records.



### Average Loan Size by MBDC

The average loan size varies widely among the MBDCs. For example, the MBDC in Wolf Point averages loans of \$6,000 as compared to the \$23,350 average loan size in Colstrip. Several factors can affect the average loan size including economic conditions of the area, type of loan, or the type of business requesting the loan. The average loan size for each certified MBDC is shown in the following chart.

**Figure 2**  
**Average Microloan Size by MBDC**



**Source: Compiled by the Legislative Audit Division from department records.**

Microloans have been used for a variety of purposes. Enterprises receiving loans include a laundromat, day care facilities, a fly-fishing shop and guide service, art and craft shops, a health club, an organic farm, and hair salons.

## Chapter II - Background

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### Program Funding

The Microbusiness Finance Program operates from a state special revenue fund. DOC operations are funded by quarterly interest payments made by MBDCs on development loans. MBDC operations are mainly funded from interest received on microloans made to microbusinesses. They also obtain funding from loan fees and interest received on deposits and investments. The program receives no funding from the state's General Fund.

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### Department of Commerce (DOC) Revenue and Expenditures

The following table illustrates DOC revenues and expenditures for program operations for the last three years.

**Table 3**  
**Department of Commerce - Microbusiness Finance Program**  
**Revenues and Expenditures**  
(FY 1997-98 through 1999-00)

	<u>FY 1997-98</u>	<u>FY 1998-99</u>	<u>FY 1999-00</u>
<u>Revenues</u>			
Development Loan Interest	\$ 115,364	\$ 138,150	\$ 143,443
Other	<u>3,234</u>	<u>1,821</u>	<u>1,795</u>
Total	\$ 118,598	\$ 139,971	\$ 145,238
<u>Expenditures</u>			
Personal Services	\$ 60,817	\$ 73,123	\$ 74,183
Operating Expenses	<u>67,968</u>	<u>45,553</u>	<u>44,277</u>
Total	\$ 128,785	\$ 118,676	\$ 118,460
Net Program Income (Loss)	(\$ 10,187)	\$ 21,295	\$ 26,778

**Source: Compiled by the Legislative Audit Division from department records.**

As the table indicates, revenues received from development loan interest generally covered the department's operating costs each of the last three years. The department has a current fund balance of approximately \$106,000. Fiscal year 1997-98 shows the department had a net loss for the year of just over \$10,000. This was caused by an unbudgeted expense when the department agreed to pay an MBDC's operating costs to administer a loan portfolio for another MBDC that went of business.

These funds came from the department's fund balance. Unlike the MBDCs currently operating, the MBDC that went out of business was not part of an umbrella entity that could subsidize its operating costs.

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### **MBDC Revenue and Expenditures**

MBDCs are funded mainly by interest collected on microloans they make. They also receive revenue from other sources such as loan fees. The original intent of the program was for MBDCs to become self-sustaining, but this has not happened in most cases. Therefore, all MBDCs are located in larger organizations, such as local economic development agencies or Human Resource Development Councils, which subsidize the cost of MBDC operations.

For several years the department did not have a system to accurately or consistently track the financial condition of the local MBDCs. Two years ago DOC began to improve the system to obtain financial information from the MBDCs. The major change was requiring MBDCs to follow Generally Accepted Accounting Principals for nonprofit entities. This change helped the department to better assess the financial status of each MBDC. The following table provides revenues and expenditures for funded MBDCs currently operating in the state for fiscal year 1999-00. This is the first year complete information under the new reporting system is available.

Due to the change in accounting requirements, the local MBDCs are now required to record bad debt expense. The amounts for bad debt expense in the table below include both current and prior year expenses.



## Chapter II - Background

**Table 4**  
**MBDC Revenues and Expenditures**  
(FY 1999-00)

	<u>Kalispell</u>	<u>Missoula</u>	<u>Butte</u>	<u>Great Falls</u>	<u>Helena</u>
<b><u>INCOME</u></b>					
Interest Rec'd from microloans	\$ 36,129	\$ 61,735	\$ 27,351	\$ 11,692	\$ 39,653
Fees Rec'd from microloans	\$ 2,982	\$ 3,950	\$ 9,165	\$ 600	\$ 2,355
Interest on deposits & investments	<u>\$ 4,344</u>	<u>\$ 17,453</u>	<u>\$ 3,001</u>	<u>\$ 10,258</u>	<u>\$ 1,767</u>
<i>Total Revenues</i>	\$ 43,455	\$ 83,138	\$ 39,517	\$ 22,550	\$ 43,775
<b><u>EXPENSES</u></b>					
Interest pd for MDOC loans	\$ 13,555	\$ 17,852	\$ 9,057	\$ 12,398	\$ 10,080
Operating Expenses	\$ 31,553	\$ 48,181	\$ 26,932	\$ 18,321	\$ 48,563
Bad Debt Expense	<u>\$ 186,193</u>	<u>\$ 30,292</u>	<u>\$ 3,850</u>	<u>\$ 4,187</u>	<u>\$ 59,194</u>
<i>Total Expenses</i>	\$ 231,301	\$ 96,325	\$ 39,839	\$ 34,906	\$ 117,837
Change in Net Assets *	(\$187,846)	(\$ 13,187)	(\$ 322)	(\$ 12,356)	(\$ 74,062)
	<u>Havre</u>	<u>Billings</u>	<u>Wolf Point</u>	<u>Colstrip</u>	<u>Total</u>
<b><u>INCOME</u></b>					
Interest Rec'd from microloans	\$ 74,437	\$ 36,022	\$ 32,062	\$ 16,596	\$ 335,676
Fees Rec'd from microloans	\$ 9,544	\$ 5,795	\$ 1,805	\$ 4,072	\$ 40,269
Interest on deposits & investments	<u>\$ 20,682</u>	<u>\$ 6,982</u>	<u>\$ 5,314</u>	<u>\$ 2,222</u>	<u>\$ 72,022</u>
<i>Total Revenues</i>	\$ 104,663	\$ 48,799	\$ 39,181	\$ 22,890	\$ 447,967
<b><u>EXPENSES</u></b>					
Interest pd for MDOC loans	\$ 39,102	\$ 14,123	\$ 17,769	\$ 5,701	\$ 139,637
Operating Expenses	\$ 40,944	\$ 50,094	\$ 28,501	\$ 15,363	\$ 308,453
Bad Debt Expense	<u>\$ 0</u>	<u>\$ 8,957</u>	<u>\$ 23,700</u>	<u>\$ 26,426</u>	<u>\$ 342,798</u>
<i>Total Expenses</i>	\$ 80,046	\$ 73,174	\$ 69,970	\$ 47,490	\$ 790,888
Change in Net Assets *	\$ 24,617	(\$ 24,375)	(\$30,789)	(\$24,600)	(\$342,921)

\* Change in net assets similar to net profit(loss)

**Source: Compiled by the Legislative Audit Division from department records.**

## Chapter II - Background

The table shows eight of the nine funded MBDCs operated at a net loss for fiscal year 1999-00. As a whole, the MBDCs had a total net loss of \$342,921. The State of Montana did not lose this money. The losses were covered by the umbrella organization where the local MBDCs are located. MBDCs in Glendive and Bozeman recently ended participation in the program. The reasons included umbrella entities no longer wanting to risk the net assets of their organizations on additional loan losses and a low demand for start-up business loans in eastern Montana.

### Bad Debt Expenses

Bad debt expenses represent the ongoing cost of probable loan losses based on estimates completed by the MBDCs. During fiscal year 1999-00, the MBDCs had a statewide total of \$342,789 in bad debt expenses. The Kalispell MBDC accounted for approximately \$186,000 of these expenses. The total for the program is 43 percent. Table 5 shows the percentage of bad expenses to total expenses for each funded MBDC.

**Table 5**  
**Percentage of Bad Debt Expense to Total Expenses**  
**(FY 1999-00)**

<u>MBDC</u>	<u>Total Expenses</u>	<u>Bad Debt Expenses *</u>	<u>Bad Debt Percentage</u>
Kalispell	\$231,301	\$186,193	80%
Missoula	96,325	30,292	31%
Butte	39,839	3,850	10%
Great Falls	34,906	4,187	12%
Helena	117,837	59,184	50%
Havre	80,046	0	0%
Billings	73,174	8,957	12%
Wolf Point	69,970	23,700	34%
Colstrip	<u>47,490</u>	<u>26,426</u>	56%
Total	\$ 790,888	\$ 342,789	43%

\* Includes prior year expenses.

**Source: Compiled by the Legislative Audit Division from department records.**



# Chapter III - Loan Portfolio Is at Risk

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## Introduction

The National Community Capital Association (NCCA), identified several indicators that call for questions to be asked about a community loan program's role and sustainability. These indicators include:

- < A loan program has a deteriorating loan portfolio.
- < A loan program finds it has limited loan production.
- < A loan program finds itself having financial difficulty.
- < A loan program has staff retention or related personnel problems.

If conditions like these exist, the NCCA recommends loan programs be evaluated. The Microbusiness Finance Program displays a number of these conditions.

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## Program Has High Microloan Delinquency Rates

The local Microbusiness Development Centers (MBDCs) track loans they make to microbusinesses on a database called the Grant Management System (GMS). This system shows how many microloans have been made, total dollars loaned, and status of loan payments for each active loan. MBDCs are required to report this information quarterly to the Department of Commerce (DOC). One report submitted to the department includes an aging report that provides information on the status of the local MBDC's loan portfolio. If loans are past due, the aging report shows how many payments loans are delinquent.

Delinquency rates are one way to measure the percentage of a loan portfolio at risk. Delinquency rate percentages are calculated by comparing the outstanding balance of loans with past due payments to the outstanding balance of the entire loan portfolio. DOC's microloan fund manual considers a loan past due when one entire cycle is completed without a loan payment. For example, a loan with monthly payments is past due when payments are 30 days late (one payment). Aging reports for the funded MBDCs for the quarter ending March 31, 2000 showed the microloan portfolios for most of the funded MBDCs had high levels of delinquent loans. Six of the nine funded MBDCs have delinquent rates over 20 percent and one over 45 percent. The statewide loan delinquency rate was 20 percent. The table below

## Chapter III - Loan Portfolio Is at Risk

provides information on late or past due payments for each MBDC. Late payments are those that have not been paid 1 to 30 days after their due date. Delinquent payments are those that are 30 or more days past due.

**Table 6**  
**Microloan Late and Delinquent Payments by Local MBDCs**  
(Quarter Ending 3/31/00)

<u>MBDC</u>	<u>Outstanding Loan Balance</u>	<i>Loan Balances With Late/Delinquent Payments</i>			
		<u>1-30 Days</u>	<u>Percentage*</u>	<u>Over 30 Days (Past Due)</u>	<u>Percentage*</u>
Billings	\$ 320,106	\$68,628	21%	\$68,849	22%
Butte	257,405	18,825	7%	57,970	23%
Colstrip	138,674	9,954	7%	33,376	24%
Great Falls	171,386	17,857	10%	76,542	45%
Havre	1,021,631	27,756	3%	209,570	21%
Helena	341,119	8,892	3%	39,901	12%
Kalispell	249,032	85,916	34%	65,698	26%
Missoula	535,197	-0-	0%	31,415	6%
Wolf Point	<u>370,859</u>	<u>23,184</u>	6%	<u>99,146</u>	27%
Total	\$ 3,405,409	\$ 261,012	8%	\$682,467	20%

\* Rounded to the nearest percentage

**Source: Compiled by the Legislative Audit Division from program records.**

As the table shows, for most MBDCs there was a general trend for loans with late payments to become delinquent. The delinquency rate would be higher if some microloans had not been rewritten.

### **Loans are Rewritten to Improve Delinquency Rates**

The DOC's microloan manual says there are occasions when it is necessary to rewrite loans in order to assist borrowers to make loan payments. For example, loans may need to be rewritten to better structure loan payments to coincide with a borrower's account receivables. For delinquent borrowers, the manual recommends rewriting loans only when significant changes occur in business status

## Chapter III - Loan Portfolio Is at Risk

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such as a major loss of customers, fire, theft or sickness. It says loans should not be rewritten unless there is clear rationale for doing so and that it will greatly increase chances of paying off the loan.

Our review of microloan files found loans that were rewritten one or more times by MBDC staff. Documentation in loan files indicated loans were often not rewritten because of changes in business status. Many of the loans were rewritten to change a loan's past due status.

Documentation from a recent department review of microloan files discussed the department's concern with this practice. Department officials recognized rewriting loans was fairly common and have discouraged local MBDCs from this practice.

Problem loans are generally rewritten to give a loan portfolio the appearance that it is stronger than it really is. Therefore, the program's overall delinquency rate would be higher if local MBDC staff had not rewritten some delinquent loans.

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### **Delinquency Rates for Program Higher Than Bank Delinquencies**

According to a study completed by the Federal Reserve Bank of Minneapolis, few clear standards exist regarding what are or are not acceptable delinquency rates for public or quasi-public loan programs. This study said it identified many examples where the rate of bad loans made by public loan programs was five to ten times higher than the private sector. We found a similar situation exists with the Microbusiness Finance program.

The Division of Banking and Financial Institutions at the DOC is responsible for conducting examinations of financial institutions around the state. Division officials said delinquencies of commercial loans in a good economy average around 4 percent and approximately 6.5 percent during poor economic times. DOC officials said judging delinquency rates for the program against those of financial institutions is not a fair comparison. This is because financial institutions are regulated and are not required to meet similar social and economic goals as the Microbusiness Program. They also indicated microloans would be expected to have higher delinquencies than commercial loans made by banks because microloans are usually made to "higher risk" borrowers.

## Chapter III - Loan Portfolio Is at Risk

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These generally include borrowers who are inexperienced, undercapitalized, and have limited cash flow and collateral. This profile is generally the opposite of borrowers who obtain commercial bank loans.

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### **Microloan Delinquencies Higher than Other Loan Programs**

There is nothing in state law, administrative rule or department policy dictating what acceptable levels of delinquency rates for the program should be. Still, DOC officials believe the current delinquency rates of a few of the local MBDCs are not acceptable because the risk of losing development loan funds is increased. To date, the program has not lost any development loan funds, but high delinquencies increase this risk.

To help evaluate the loan portfolio for the microbusiness loan program, we compared delinquency rates for the program to delinquency rates for other public or quasi-public loan programs. Delinquency rates for the Microbusiness Loan program are higher than many of these other programs.

### **Aspen Institute Studied Other Microbusiness Assistance Programs**

The Aspen Institute conducted a study in 1996 called the Self-Employment Learning Project which reviewed microbusiness assistance programs in other states. The study included a review of seven revolving loan fund programs that make loans to microbusinesses in these states. This study used delinquency rates to help measure the quality of the portfolio. The study calculated the portfolio at risk by measuring the number of loans in the portfolio that missed one or more payments. This study found the average delinquency rate (one payment or more) for the seven revolving loan funds reviewed was 21.6 percent.

The study stated that measuring the quality of portfolio performance is not easy. This is because little information has been gathered on the portfolio quality of microenterprise programs in the U.S. There is also no consensus regarding appropriate measures or acceptable ranges of performance.

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### Other State Revolving Loan Funds Have Lower Delinquencies

In 1997, the Corporation for Enterprise Development (CFED) reviewed various types of revolving loan fund programs in seven states. One area examined included the delinquency rates for these funds. This study found the loan programs reviewed in most other states had lower delinquency rates than Montana's Microbusiness Finance Program. Table 7 provides information on the delinquency rate for revolving loan programs in other states.

**Table 7**  
**Delinquency Rates**  
**Other State Revolving Loan Funds**

<u>State</u>	<u>Delinquency Rate</u>
Arkansas	26.50%
Ohio	18.00%
North Carolina	17.50%
California	12.60%
Illinois	10.70%
Minnesota	8.80%
Washington	8.70%

**Source: Compiled by the Legislative Audit  
Division from CFED data.**

#### **Conclusion #1**

**The overall Montana microloan portfolio has a high  
delinquency rate and potential for significant loan losses.**



## Chapter III - Loan Portfolio Is at Risk

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### **Potential Loan Write-Offs Could Be Higher Than What Program Reports**

Once delinquent loans become 90 days or more past due, collection of the loan is doubtful. When this occurs loans should generally be “written-off” or removed from the loan portfolio because they are no longer earning income. We believe the actual loan loss may be higher because some MBDCs are hesitant to write off problem loans. An indication the loan loss could be higher would be a recent write-off of six microloans totaling \$128,000 at one MBDC. This was 32 percent of the dollar value of its loan portfolio. Program officials said the MBDC continued to leave the loans on the books in hope of collecting them despite all the loans being over 200 days past due. One loan was a year-and-a-half past due (558 days) and another was almost a year past due (344 days).

Department records indicate this is a common scenario for most MBDCs around the state. We found the total dollar value of loans 90 days or more past due (for the quarter ending March 31, 2000) was approximately \$405,000. This is more than half the dollar value of the program’s delinquent loans and just under 12 percent of the current loan balance. In addition, there is an outstanding balance of another \$143,000 which could potentially become 90 days past due because borrowers have not made their last two payments.

For some MBDCs there was a general trend for delinquency balances to increase from 30 days past due to 90 days or more past due. This is the opposite trend found at most lending institutions where delinquencies generally get smaller between 30 and 90 days.

During the audit, the department questioned the accuracy of the loan write-off data maintained on the Grant Management System. The system showed approximately \$640,000 had been written off since program inception. DOC officials thought his figure was low. To address their concern, DOC requested each MBDC provide detailed information on every loan written off since program inception through March 31, 2000. The department found the total cumulative loan losses through March 31, 2000, exceeded \$750,000.

### **Conclusion #2**

**The department reports that cumulative microloan write-offs are just under eight percent. However, the amount written off is generally understated compared to what actually exists because doubtful loans are often kept on the books.**

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### **Number of Loans Made**

The NCCA says a loan demand problem may stem from a variety of causes. For example, a program may adopt a loan portfolio definition that is too broad or narrow, have a limited geographic scope, borrowers could have limited capacity to use debt, the lending process could be too rigid, or there could be external factors related to funding or competition.

The following table illustrates the number of loans made in each region since program inception for regional MBDCs. It also shows the number of loans made for each of the last two years.

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**Table 8**  
**Number of Microbusiness Loans Made**  
 (July 1, 1992, through March 31, 2000)

<u>Region Number</u>	<u>MBDC Location</u>	<u>Total Loans Made</u>	<u>Loans Made Last Two Years</u>	
			<u>CY 1998</u>	<u>CY 1999</u>
Region I	Kalispell	55	5	5
Region II	Missoula	97	23	12
Region III	Butte	36	5	6
Region IV	Great Falls	25	2	1
Region V	Helena	110	9	10
Region VI	Bozeman	41 *	4	0
Region VII	Havre	108	13	21
Region VIII	Lewistown	31 **	5	0
Region IX	Billings	79	13	14
Region X	Wolf Point	43 ***	8	4
Region XI	Glendive	22 *	0	0
Region XII	Colstrip	<u>10</u> ***	8	1
Total		657		

\* No longer in program; repaying its development loan to department.

\*\* Lewistown is certified but not funded. Its development loan has been repaid and it currently makes loans from interest earned from microloans repaid.

\*\*\* Took over loan portfolio for Region XI (Glendive) when it left the program.

**Source: Compiled by the Legislative Audit Division from department records.**

As the table shows, the total number of loans made since the inception of the program varies widely from region-to-region. Numbers range from 10 loans in Colstrip to 110 loans in Helena. We also noted some MBDCs have made very few loans in the last two years of the program. For example, one MBDC made two loans in calendar year 1998 and only one loan in calendar year 1999.

Department officials and MBDC staff indicated reasons for the variances could include more liberal or conservative lending philosophies between MBDCs, some regional loan programs not quite "getting off the ground," vacant lending positions at MBDCs, and some

## Chapter III - Loan Portfolio Is at Risk

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MBDC umbrella entities placing more emphasis on other programs within their entity. Another possible reason for limited loan output in some regions could be related to local economic conditions or the number of people living in the area. The Microbusiness Advisory Council believes more financing sources of less than \$35,000, such as credit cards and home equity loans, are now available to borrowers that were not available in 1991 when the program was created. Some council members believe financing sources like these have impacted the number of loans made by the program.

### **Conclusion #3**

**Variances exist between MBDCs in the number of loans made, and the number of loans has dropped in some areas during the last two years.**

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### **MBDCs Are Having Financial Difficulties**

Several years ago one MBDC went out of business. Department officials indicated this occurred because it was a stand alone MBDC and was not located within another entity, such as an economic development agency. Department officials said MBDCs need to be located within a financially sound organization that can help subsidize the operating costs of the MBDC. Since this MBDC was not part of another entity, department officials said it could not generate sufficient income to remain open. Financial difficulties within a loan program may stem from several factors including insufficient financial and portfolio management, poor fundraising, or an inability to influence key public and private sector officials. In almost all cases, the NCCA attributes financial problems of a loan program to the absence of planning.

We reviewed financial information reported to the department by each active MBDC for fiscal year 1999-00. As shown in the Table 4 on page 16, the total statewide net loss (expenses exceeding revenues) for all the MBDCs was \$342,921. Only one of the nine active MBDCs showed a positive change in net assets.

The umbrella organization covers the losses experienced by the MBDC, not the State of Montana. Department officials said the average amount these organizations spend to subsidize operations at each MBDC is

## Chapter III - Loan Portfolio Is at Risk

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\$31,000 per year. These are funds that can not be used for other programs within the umbrella entity. Two MBDCs (Bozeman and Glendive) chose to leave the program because the entities where they were located no longer wanted to risk the net assets of their organizations on additional loan losses.

State law requires MBDCs to have sufficient sources of operating funds to cover costs. The major source of income for most MBDCs is interest earned on microloans made to borrowers. Some MBDCs have also obtained additional funding through grants but these are generally not sufficient or constant enough to solve the majority of the MBDC's financial problems. Based on discussions with department officials and MBDC staff, most MBDCs will not be self-sustaining as intended by the legislature in passage of the Microbusiness Development Act.

### **Conclusion #4**

**Most MBDCs are not financially self-sustaining, and it is unlikely they will be as intended by the legislature.**

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### **Weaknesses Exist with Lending Procedures**

We evaluated the lending procedures by local MBDC staff. Our review identified several weaknesses with the local programs' lending procedures. Examples of these are discussed below:

- < Business plans were not always obtained or lacked sufficient detail to allow some MBDCs to evaluate a new business proposal. Business plans define how an applicant will turn a business idea into a reality. They outline the mission of the proposed business, the scope, goals and objectives, risks, and strategies to address these risks. A business plan is an important step to ensure loan applicants have thoroughly considered all aspects of their business idea.
- < Financial/credit analysis of microloan proposals was limited or nonexistent at some MBDCs. For example, the historical cash flow for existing businesses was often not reviewed nor were steps taken to determine if projections for a new business were reasonable. Other factors that were often not analyzed included competition, the demand for the product, industry trends, or a review of management/owner ability to operate a business.

### Chapter III - Loan Portfolio Is at Risk

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- < Financial information was not always obtained when loans were made. For example, one MBDC approved a loan for an individual who had previously obtained a loan through the program. However, updated financial information was not obtained even though the information on the file was two years old. In cases where an MBDC required a third-party to guarantee the loan (guarantor), financial information was not always obtained from the guarantor to assess their ability to repay the loan.
- < Security is taken on microloans in the form of collateral. Collateral taken often includes vehicles, mortgages, and business assets such as inventory or accounts receivable. We found liens were not always filed on collateral to ensure the MBDC was shown as lien-holder and had a legal right to repossess the collateral in the event the borrower defaults on a loan. Furthermore, documentation often did not exist indicating collateral was insured in the event it was stolen or destroyed.
- < Some MBDCs made loans to applicants with poor credit histories including bankruptcies and unpaid collections. In some cases, credit reports were not obtained or were obtained after a loan was made.
- < A loan was made to pay personal expenses for a borrower rather than help cover operating costs for operating a business. The borrower filed bankruptcy approximately a month later despite being provided these funds.
- < Most MBDCs were not actively managing their loan portfolios. For example, MBDCs generally did not obtain on-going financial information from their borrowers and had limited contact with borrowers after a loan was made. There was also limited review of loan portfolios by MBDC staff on a regularly scheduled basis to help identify potential problems in a timely manner.
- < An example was found where loan documents were not signed when a new loan was made to an existing borrower. Consequently, the amount of money provided to the borrower is more than what is stated on loan documents in the file.

#### **Conclusion #5**

**There are weaknesses with lending procedures followed by some local MBDC lending staff.**



## Chapter IV - Legislature Should Determine Program's Future

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### **NCCA Recommendations Strategic Planning**

Strategic planning is a form of long-term planning that defines future direction. The process is a commitment to action based on an analysis of a program and a vision of what the program should become. The legislature should be involved in determining the future of the Microbusiness Finance Program. Strategic planning also identifies what an organization will do and provides a basis upon which performance and day-to-day decisions can be evaluated.

The National Community Capital Association (NCCA) developed guidelines for administering community development loan funds. According to the NCCA, long-term strategic planning is key to maintaining credibility of a community development loan fund. It notes a good planning process helps build the long-term capacity of an organization and increases its likelihood for success. The NCCA cites four reasons why loan funds should have a strategic plan.

- < Assists an organization to achieve operational success and longevity.
- < Builds internal consent regarding direction of the program.
- < Creates objective criteria for assessment and accountability.
- < Communicates to stakeholders and customers regarding the organization and its future.

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### **Program Re-evaluation Needed**

We found the program has a weak loan portfolio, most MBDCs are not financially self-sustaining, loan activity is dropping in some areas, and, as discussed later in the report, the program has difficulty maintaining/attracting qualified staff. In addition, many involved with the program have different perceptions of the purpose of the program. The following provides examples of the differing staff perspectives.

- < The program is designed to make loans to “high-risk” borrowers, such as those with poor credit histories.
- < The program provides opportunities for people to establish a livelihood despite the risk of the loan.



## Chapter IV - Legislature Should Determine Program's Future

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- < The program is a “lending program” and provides capital to new and expanding businesses and risk should be avoided.
- < The program “takes chances” to give people an opportunity to raise their life status.
- < The program is generally designed to keep existing businesses going and keep them part of the community.
- < The program is generally designed to help people and if it creates only one job then it has been a success.

State law indicates the purpose of the Microbusiness Development Act is “to create a program to encourage and assist in the creation, development, and financing of businesses with fewer than 10 employees and gross revenues of less than \$500,000 a year.” However, the act also requires various social aspects be addressed such as providing services to minorities, women and low-income persons. Department officials indicated the program may never have had a uniform focus on the purpose of the program.

Department officials said several challenges exist in directing the future of the program, such as identifying ways to bring MBDCs closer to financial self-sufficiency. Based on our review, the program is not structured to allow for effective program administration. We believe the legislature should consider changing the organizational structure of the program. The following provides examples that could help reduce the overall operating costs of the program while still providing geographic coverage in the state.

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### **Reduce the Number of MBDCS and Combine MBDC Regions**

State law allows for “up to twelve” MBDCs to be active in the state. There are currently nine active MBDCs operating in the state and there has been as many as twelve. DOC officials indicated it is difficult to find entities interested in housing an MBDC because of the effort and cost involved in administering the program. An important criteria is that an umbrella entity be strong enough financially to help cover the costs of the program and this is a limitation in finding a new entity. The department said while umbrella entities where some MBDCs are now located are sound financially, the financial strength of others are questionable. They also said there are umbrella entities who are

## **Chapter IV -Legislature Should Determine Program's Future**

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currently covering the costs of the program but are not sure they want to continue to do so. If this happens, the program will not be able to provide services in that part of the state.

The program could help reduce some operating expenses by reducing the number of MBDCs and combining MBDC regions. The department could gain some efficiencies in reducing the number of MBDCs because it does not need a full MBDC to make five or fewer loans a year.

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### **Partner with Financial Institutions**

Section 17-6-407, MCA, allows development loans to be used to guarantee loans made by financial institutions. Another option the program should consider is developing more partnerships with financial institutions around the state to make microloans. The financial institution would take on the role of the MBDC. This would help provide geographic coverage in the state and result in less of a need for active MBDCs in the area. Based on our conversations with bank officials they would be willing to consider this option. There would be a need for offsetting controls if a change like this were made. For example, the program may need to review a bank's loan documentation similar to what the Small Business Administration (SBA) does for SBA Guarantee Loans. An effective system for banks to report loan activity would also be needed to obtain information such as the number of loans made and loan performance. However, this change would reduce operating costs by reducing the need for several MBDCs operating in the state. It also ensures experienced lending staff are making loans.

DOC officials believe if such a change were made, banks would not provide needed technical assistance to the borrowers. They indicated a process is needed to ensure assistance is available.

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### **Legislature Needs to Determine Future of Program**

The department and the Microbusiness Advisory Council performed strategic planning to identify ways to solve problems facing the program. Some potential solutions they identified involve transferring program administration to a private party, obtaining additional funding from the Coal Tax Trust Fund, and establishing specific expectations regarding loan loss rates. The proposals developed by the department

## **Chapter IV - Legislature Should Determine Program's Future**

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and the advisory council are issues that would need legislative consideration.

The legislature needs to determine the future of the Microbusiness Finance Program. It is not clear whether the program has performed at a level acceptable to the legislature. Base on criteria developed by the NCCA, the program meets the conditions requiring a determination of its future, if resources were appropriately committed, and if the program was effectively administered.

### **Recommendation #1**

**We recommend the legislature determine the future of the Microbusiness Finance Program.**

# Chapter V - How Could Program Operations Be Improved?

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## **Introduction**

In the previous chapter we recommended the legislature determine the future of the Microbusiness Finance Program. This chapter contains recommendations to improve program operations.

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## **MBDC Staff Have Limited Training**

The Microloan Fund Management Manual indicates the mistake often made is believing that because microloans are small they are easier to make or imply little risk is involved. However, micro-lending and managing a microloan portfolio present some of the most difficult lending and management tasks possible. This is because these loans are made to businesses with little or no track record, the availability of limited financial information, limited cash flow and collateral, and borrowers having limited experience in operating a business. Therefore, local MBDC staff should actively manage loan portfolios. Information from the Colorado Graduate School of Banking indicates one of the most important steps in establishing an effective “credit culture” is ensuring credit staff are qualified and appropriately trained. Loan committees make the final decision on whether to approve loans based on information provided by loan officers. Consequently, a loan committee is only as good as the information it receives from lending staff.

The high loan delinquency rates and problems with the lending procedures followed by MBDC staff indicate there is a lack of understanding of proper lending procedures among the MBDCs. The majority of MBDC staff we interviewed do not believe they received sufficient training on proper lending practices. They believe training is critical because loan officers hired by local MBDCs often have little or no lending experience. MBDC officials indicated many loan officers obtain their knowledge of lending through “on-the-job training.” Therefore, they believe many bad loans were made because lending staff was not properly trained. MBDC staff said the main reason they have not received sufficient training is because the MBDC does not have enough money to send staff to training.

MBDC officials also attribute the program’s delinquency rates to high turnover in lending staff. Our review of MBDC operations found many

## Chapter V - How Could Program Operations Be Improved?

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MBDCs have difficulty keeping staff for extended periods of time. For example, one MBDC has had three loan officers in the last year. MBDC and DOC officials indicated it is difficult to maintain consistent lending procedures and portfolio management practices when turnover like this occurs. High rates of staff turnover make on-going training programs even more important.

DOC officials agree many MBDC staff have limited lending backgrounds and lack of training and staff turnover are issues that need to be resolved. They believe there is always going to be a certain level of on-the-job training but said MBDC staff need to receive on-going training to effectively manage microloans. DOC officials make credit-related training available to MBDCs. In the last two years at least 10 training courses were offered. The department also receives discounts on training through the Montana Bankers Association to try to make training more affordable for MBDCs. Even so, DOC officials said MBDC staff often do not attend training that is offered. DOC staff said costs play a role in whether MBDC staff attend training, but they also believe some MBDCs have not made a concerted effort to attend training that is made available. The MBDCs may not have funds available to pay for training, but the “umbrella” entity where an MBDC is located could help with some of the cost of staff training.

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### **Positive Correlation Exists Between Training and Low Delinquency Rates**

During our review, we noted a positive correlation between MBDC staff who receive on-going training and prudent lending practices. For example, one MBDC had significantly lower delinquency rates than any other MBDC in the state. Our reviews of their microloan files found they follow a consistent and detailed lending process. This includes conducting an in-depth credit analysis of each loan proposal. They also actively manage their portfolio by meeting at least monthly with the borrower to discuss each loan in the portfolio and conduct frequent visits with each borrower. Some of this may be due to the MBDC being located in an area with a relatively good economy. However, MBDC and DOC officials also attribute this to hiring staff with lending backgrounds and providing lending staff with on-going training.

## Chapter V - How Could Program Operations Be Improved?

### **More Resources Could Be Provided to Increase Training**

Administrative rules require MBDCs to have a plan detailing staff education, qualifications, and experience. Many of the problems identified with the lending process and the high delinquency rates are due to MBDC staff not having sufficient knowledge of proper lending procedures. Examples of areas where MBDC staff would benefit from additional training include loan documentation, credit analysis and loan collections. Most local MBDCs cannot afford the entire cost of staff training and believe the DOC should pay at least a portion of training costs. The DOC could make additional resources available to help MBDCs provide training to their lending staff. These resources could be in the form of grants, department training, or funding from the state's program fund balance. One step in this decision should be to contractually require MBDC staff obtain a certain amount of loan-related training. In a written response to our concerns, department officials said they intend to seek legislative approval to spend \$10,000 per year on MBDC staff training. This would be funded from the fund balance in the department's administrative special revenue account.

#### **Recommendation #2**

#### **We recommend the Department of Commerce:**

- A. Make additional resources available to MBDCs to provide training to staff.**
- B. As part of contract renewal, require lending staff to complete specific loan-related training.**

### **DOC Should Conduct More Active Reviews of MBDCs**

State law and administrative rule make DOC responsible for ensuring development loan funds provided to local MBDCs are administered by the MBDCs in an effective manner. Section 17-6-407, MCA, requires MBDCs to have the ability to manage a microloan portfolio and authorizes DOC to approve and certify an MBDC once it provides evidence of its ability to do so. Administrative Rule (ARM 8.99.404) specifically requires MBDCs to provide the following information to DOC for review:

- < A plan for credit investigation and financial analysis.

## Chapter V - How Could Program Operations Be Improved?

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- < A plan outlining their ability to properly document loans, monitor borrowers, and manage and collect delinquent loans.
- < A plan detailing staff education, qualifications and experience.

DOC reviews and approves this information when a new MBDC is approved or when MBDCs are recertified every four years. Based on our review, DOC should be reviewing the ability of MBDCs to administer revolving loan funds more frequently. The following sections discuss some areas where DOC could be more involved.

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### **DOC Should Establish Minimum Qualifications of MBDC Staff**

Due to the high turnover and hiring staff with little or no lending experience, DOC officials said they would like to establish minimum qualifications that local lending staff must meet. At the present time DOC does not specify what qualifications local lending staff must meet. DOC officials also believe they should be more involved in ensuring lending staff meet these qualifications. They said they review the qualifications of local staff every four years when MBDC contracts are renewed but do not have the authority in the statute and rules to do this any more frequently.

DOC has not established criteria to evaluate whether MBDC staff have the ability to administer microloan funds. This is needed since many MBDCs are hiring staff with little or no experience in lending. Since statutes give DOC the responsibility for ensuring MBDCs have the ability to effectively administer this program, DOC also has the authority to establish minimal qualifications for MBDC lending staff. DOC should also incorporate an evaluation on whether local MBDCs are hiring staff who meet the minimum qualifications as part of DOC's annual on-site review of MBDC operations.

## Chapter V - How Could Program Operations Be Improved?

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### **Recommendation #3**

**We recommend the Department of Commerce:**

- A. Establish minimum qualifications for MBDC lending staff.**
- B. Evaluate whether MBDCs are hiring staff that meet the minimum qualifications.**

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### **Lending Policies and Procedures are Vague**

Information from the Colorado Graduate School of Banking indicates lending policy directly impacts the effectiveness of the lending process and establishes the framework for lending. During our review, we noted MBDC lending policies are not clear. Department officials indicated the MBDC policies focus more on ensuring an applicant's ability for a hearing if he/she is turned down for a loan rather than a process for making good loans. One reason for this is that MBDCs used sample procedures during the initial certification process that focused more on the hearing process than the lending process. Given the frequency of local staff turnover, policies and procedures clearly defining the lending process are even more important.

DOC should require all MBDCs submit their procedures to DOC for approval. Since some MBDCs may not be familiar with how to write lending procedures, the department may need to provide samples for the MBDCs to follow. DOC officials said in a written response that they requested copies of current lending policies and procedures from all MBDCs. They will review them and recommend MBDCs adopt new policies and procedures if the current ones do not provide sufficient direction on how to control portfolio risk.



## Chapter V - How Could Program Operations Be Improved?

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### **Recommendation #4**

**We recommend the Department of Commerce:**

- A. Provide sample policies and procedures to MBDCs describing the proper lending process.**
- B. Review and approve MBDC lending policies and procedures.**

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### **Some Microloans Did Not Comply with State Law**

During our review of microloan files, we found MBDC staff made loans that did not comply with the requirements of the Microbusiness Development Act (Title 17, chapter 6, MCA). These included eleven loans that exceeded the \$35,000 limit established by state law. Based on interviews with local MBDC staff, this occurred because staff financed loan fees into the loan.

MBDC staff said a previous DOC program manager authorized them to exceed the \$35,000 lending limit. They said this decision was made to allow borrowers that could not afford to pay finance fees to still obtain the maximum loan amount.

### **Agency Action: MBDCs Notified to Comply With Law**

We notified DOC of this practice during the audit. DOC subsequently notified all MBDCs the \$35,000 loan limit is not to be exceeded for any reason.

# Chapter VI - System Needed to Measure Outcomes

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## Introduction

Based on our review of the Microbusiness Development Act (Title 17, chapter 6, MCA) and interviews with department officials, the legislature had a number of expectations for the Microbusiness Finance Program. These included:

- < Fostering economic development.
- < Creating jobs and personal earnings for Montana residents.
- < Providing a financing mechanism for small businesses that do not have access to conventional financing.
- < Providing entrepreneurial training to small business.
- < Providing opportunities to women and low-income persons.

According to the National Community Capital Association, public loan funds should have criteria for assessment and a system to measure performance to ensure accountability to “stakeholders.” For the Microbusiness Finance Program, stakeholders include the legislature, the public, MBDCs, and borrowers.

DOC has approximately \$5 million contracted with MBDCs for the purpose of making microloans with over \$3 million loaned to microbusinesses. At the present time neither DOC nor the MBDCs know for sure how many businesses financed through the program are still operating. DOC does not have a system in place that allows them to evaluate the outcomes of the Microbusiness Finance Program and whether the expectations of the Microbusiness Development Act are being met.

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## Consultant Reviewed Program in 1994

In 1994, a private consulting firm hired by DOC to review the program made the following conclusions.

- < The majority of businesses receiving microbusiness loans were already in operation or at least operating on a limited scale.
- < Most businesses receiving microbusiness loans said they would not have been able to open or stay in business without the loan.

## Chapter VI - System Needed to Measure Outcomes

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- < One way to assess microbusiness contributions to state and local economic development is to measure the extent a business sells its product or service outside the local economy. Examples include selling products to out-of-town travelers, non-local businesses, or to state and federal government agencies. In theory, this brings outside money into a state or local economy that stimulates economic growth. About 75 percent of Montana's microbusinesses cater mainly to residents and businesses in their immediate area. Therefore, they make a limited contribution to statewide or local economic growth. Additionally, most microbusinesses are mainly competing with other businesses in their area.
- < The program has not resulted in substantive movement off public assistance.

According to department officials, the program was not designed for poverty alleviation nor was it funded to operate as a poverty alleviation program.

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### **No Systematic Approach to Measure Outcomes**

Our review of the program's loan portfolio identified a number of weaknesses exist with the program's lending procedures. As a result, the overall portfolio has a high delinquency rate and potential for significant loan losses. For example, over half of the current delinquencies are 90 days or more past due so collection of the loan is doubtful. While loan delinquency rates are one means to evaluate program outcomes, it does not necessarily provide the "big picture" of the program's outcomes.

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### **Outputs vs. Outcome Measurements**

The department developed a tracking system for the program called "Measures of Microloan Program Impact." This system, however, tends to concentrate mainly on outputs of the program instead of outcomes. Output indicators focus on the level of activity for a program and measure the amount of product provided or the number of customers served. For example, the department tracks the number of loans made, how much money has been loaned, and the average loan size. While this information provides department management with information related to the level of the program's lending activity, it does not measure the impact of the program to the state.

## Chapter VI - System Needed to Measure Outcomes

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Outcome indicators measure program and policy results and evaluate the overall impact of program activities. They are important performance measurements because they show whether or not expected results are being achieved. For example, outcome measurements for the program would show whether legislative expectations of the Microbusiness Development Act were being met.

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### Accuracy of Jobs Created/Retained is Questionable

A Federal Reserve study of public loan programs noted the most common outcome measurement for public loan programs is tracking the number of jobs created and retained. But the study said a weakness of tracking this information is loan programs often take credit for every job created or retained by a business that obtained a loan through their program.

The Microbusiness Finance Program tracks the number of jobs created and retained. We evaluated the department's process for compiling this data by reviewing department records and interviewing DOC and MBDC staff. Based on our review, we identified weaknesses in the process used to compile this information which raises questions as to the accuracy of this data.

We noted the Microbusiness Finance Program often provides "gap financing" to borrowers. Gap financing provides funding that another loan source, such as a bank or another public loan program, will not provide. We found the program generally takes credit for the jobs created or retained even though other programs played a role in financing a business. Often times the other financing source may have played a bigger role by providing larger sources of funding than the Microbusiness Program. DOC officials said they count these jobs because without the gap financing a business most likely would not have received the funding it needed. However, a similar argument can also be made for the other funding sources. Additionally, if another financing source was a public loan program, the number of jobs created or retained in the state would be counted twice.

Department records indicate that since inception, the program has created 730 new jobs in the state and retained over 560 existing jobs. We noted, however, the department relies on estimates provided to the

## Chapter VI - System Needed to Measure Outcomes

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MBDCs when loan documents are signed. Based on our discussions with MBDC staff, limited verification takes place to ensure the accuracy of the information provided. For example, most MBDC staff said on-site visits or surveys of borrowers are generally not completed. During our review of the program's loan portfolio, we found examples where business ventures were unsuccessful and the loan was written-off. We also noted examples where businesses were unsuccessful and borrowers obtained other employment so they could pay off the loan. Our review of department records and discussions with department officials found the DOC's records for jobs created or retained are not updated to account for these situations. The program continues to report jobs created and retained that no longer exist. Consequently, there is generally no direct link between loans made and the number of jobs the program has reportedly created and retained.

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### Other Loan Programs Verify Information

DOC administers the state's Community Development Block Grant (CDBG) program. This revolving loan program provides financing to local development projects when a funding gap exists or alternative sources of financing are not sufficient or available. Like the Microbusiness Finance Program, loans are generally made by a local entity. During our review, we noted this loan program has a system to help assess the outcomes of the program. Borrowers are annually surveyed to obtain data on the number of jobs created, salary levels, job status (full-time or part-time), employee gender, and hours worked each week.

Other states are also trying to improve how they measure the impact of some public loan programs. The Federal Reserve indicated North Dakota is not only tracking new jobs but has also begun to gauge the "wealth effect" by measuring the impact of the jobs on a community's standard of living. Additionally, Minnesota tracks wage rates and also a loan's impact on the local property tax base.

## Chapter VI - System Needed to Measure Outcomes

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### **Microbusiness Could Use Other Indicators**

As noted above, other loan funds are gathering outcome data in addition to jobs created and retained. The Microbusiness Finance Program could also obtain additional information to better evaluate what impact the program is having on the state and the local communities. Examples of information that could be compiled include income and corporate taxes paid, property tax revenue, annual gross revenues for borrowers, and business profits.

At the present time neither the department nor the MBDCs know for sure how many businesses financed through the Microbusiness Finance Program are still operating. Documentation from the Small Business Administration shows about half of small businesses go out of business within the first four years. Another outcome measurement could be to track how many businesses that obtained financing from the program remain open for at least this long.

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### **The Department Recognizes Improvements are Needed**

Department officials recognize the weaknesses of the current system used to evaluate the impacts of the Microbusiness Finance Program and the need to improve the system. In March 2000, the department tried to obtain information from the Department of Revenue (DOR) on taxes paid by businesses that obtained financing through the program. Due to confidentiality issues, the DOR has not provided this data.

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### **Establish Outcome Measurements and a Process to Compile Data**

There are several outcome measurements that could be used by the department to evaluate the program such as jobs created, tax information from borrowers, and/or business profits. The department needs to determine the information needed to measure program outcomes and then decide the most effective means for obtaining this data. The outcome measurements must show whether or not the state is realizing a greater benefit than the costs of funding the program. The department must also determine how to gather this data on an on-going basis.

The Urban Institute identifies ways to improve government decisions and performance. They suggest an effective method for obtaining outcome data is through the use of surveys. This is a method that is currently employed by other loan programs and could also work for the Microbusiness Program. In a response to our concerns, department

## **Chapter VI - System Needed to Measure Outcomes**

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officials agree outcome measurements are needed. They said they must consider the cost of developing a system in terms of time and resources of the microbusinesses and the MBDCs. They said they intend to measure gross revenues, net taxable income, gross payroll, and the actual number of jobs created. They indicated they would implement a system of surveying microloan borrowers to obtain impact information.

### **Recommendation #5**

**We recommend the Department of Commerce:**

- A. Develop outcome measurements for the Microbusiness Finance Program.**
- B. Establish a system to collect information and measure program outcomes.**

## **Agency Response**

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MEMORANDUM

NOV 3 2000

TO: Legislative Audit Division

FROM: Peter S. Blouke, Director *P.S. Blouke*  
Department of Commerce

RE: Response to Performance Audit Report on Microbusiness Finance Program

DATE: November 3, 2000

Please consider this the formal response to the Performance Audit Report conclusions and recommendations regarding the Microbusiness Finance Program.

DEPARTMENT OF COMMERCE RESPONSE

The Department of Commerce concurs with many, but not all, of the conclusions made by the auditors and appreciates the extensive efforts of the auditors in their research and analysis of this very important program. The Microbusiness Finance Program has directly and positively impacted hundreds of Montana businesses by enabling them to start up and expand their operations. The Microbusiness Development Corporations that serve microbusinesses of Montana include local boards that are directed by over one hundred professional bankers, certified public accountants, local government officials, business owners and interested taxpayers.

The Department's response will be organized by the numbered findings and recommendations made in the final draft report received on October 31, 2000.

Conclusion #1:

*The average statewide delinquency rate of 20% compares favorably to the microloan programs involved in the Aspen Institute Study referenced in the audit report. The risk of loan losses is almost entirely borne by the MBDC not the State of Montana. Only in the event that an MBDC should default on its obligation to the State, would the program present some risk of loss of state development loan funds. Because the Department required the MBDCs to use the Grant Management Loan Portfolio Management System (GMS), the program has much more accurate information concerning the quality of the loan portfolio than most RLFs or microloan programs.*

The local Microbusiness Development Corporations (MBDCs) have different lending policies and different delinquency and loss rates which make it difficult and somewhat unfair to make judgements or assessments about the program on a statewide basis. Lending to Microbusinesses or start up businesses is by its very nature a risky business. It is riskier than most other lending programs offered by non-profit revolving loan funds or community development financial institutions. While the Department believes that some of the MBDCs need to improve their lending practices and reduce their delinquency rates, we feel that several of our MBDCs are doing an outstanding job of managing their programs.

A closer analysis of the data supporting the wide range of delinquency rates reported in the various Corporation for Enterprise Development (CFED) State RLF studies shown in Table 7, reveals there is not a uniform definition of "delinquency". In Minnesota, which had a reported delinquency rate of 8.8%, half of the RLFs could not even define delinquency. Illinois had a reported delinquency rate of 10.7% because only 40 percent could define delinquency. The CFED studies involved all RLFs, not only microloan programs. The median loan size for the Illinois RLFs was \$37,433. The median loan size for the Minnesota RLFs was \$71,000. This indicates that these RLFs are probably involved with larger businesses, not microbusinesses. It is unfair to make comparisons between RLFs in general and the program that exclusively reports only eligible microloan activity.

The Department has partnered with CFED and the Montana RLF industry to conduct a similar statewide RLF survey and the results should be available for the 2001 Legislative Session. This survey allows the MBDCs to report all of their lending activity, not just the highest risk microloan program.

#### Conclusion #2:

*Any local match that has been lost is being replaced. The entire net asset value of all the funds is essentially intact. The Department believes that the cumulative loan loss rate as of March 31, 2000 of 7.6 percent and the total cumulative loan losses of \$754,961 are accurate. The National Community Capital Association (formerly known as the National Association of Community Development Loan Funds) surveyed fifty-one Certified Community Development Financial Institutions (CDFIs). CDFIs are considered the cream of the crop for non-profit revolving loan funds. For CDFIs with less than \$2 million in capital under management, the average cumulative loan loss rate was 8.2%. Only 71 percent of the loan activity of these CDFI's was microlending. We believe that our cumulative loan loss rate of 7.6 percent demonstrates above average performance for our program as a whole.*

There is always a potential that loans that are kept on the books may not be collected in full. That is one reason why the Department has stressed the importance of following Generally Accepted Accounting Principles (GAAP), which require the MBDCs to assess the probability of loan losses and set aside an allowance account to reflect the net estimated collectible value of their outstanding loan portfolio. The total allowance for loan losses for the MBDCs as of March 31, 2000 was \$378,000 or 10.3 percent of the outstanding loan balance.

In fact, we believe that our efforts to train and encourage the MBDCs to use good loan portfolio management tools has improved our financial information to the point that is substantially higher than average for RLFs. Non-profit revolving loan funds are not subject to the same regulations that FDIC insured financial institutions must follow. They also do not receive the same income tax benefits that for-profit lenders gain from reporting loan losses. By their very nature, microlenders and RLFs carry loans on their financial statements until they have exhausted all possible collection activities.

#### Conclusion #3:

*The current statewide loan out rate of 63 percent is comparable to rates maintained by other financial institutions including banks.*

The loan activity is down over the past two years, compared to prior years, for most of the MBDCs. Prior to November of 1998, the MBDCs were required by the terms of their loan agreements to maintain a minimum loan out rate of 80 percent. That policy was changed in November 1998 at the request of a group of MBDCs. They argued that the policy unnecessarily pressured them to make loans even if they could not maintain quality-underwriting guidelines. Since many of our MBDCs serve areas that have suffered from economic distress, the rate of their loan activity should fluctuate with the cycles of their local economies. The Administrative Officer for the program also researched the policy and found that the National Community Capital Association (NCCA) and others recommend the opposite, that an RLF should not exceed a loan out rate of 80 percent because of liquidity needs. Other factors influence lending activity at the local level. Two of our most active MBDCs experienced turnover when microloan officers with many years of experience left the programs for better paying positions. Because successful microlending is very dependent upon the relationship between the loan officer and the borrower, a new loan officer must first familiarize themselves with the current borrowers before they have time to solicit and market for new borrowers. This is important to reduce the risk of loan losses.

#### Conclusion #4:

*The MBDCs are located in financially sustainable organizations. On average, not taking into consideration the cost of loan losses, the MBDCs are operating their microloan programs at break-even. The cost that is most difficult for the MBDCs to absorb is the bad debt expense. The average interest rate charged by MBDCs is about 12%. Even though the cumulative loss rate of 7.6 percent is average or better than average, it is easy to understand how the 9 percent interest rate spread cannot adequately cover this cost for relatively small loan funds. Larger loan funds will generate additional income to cover administrative costs and loan losses as an economy of scale. Our largest MBDC actually generates more revenue than expenses in operating the microloan program.*

*The Department does not believe that the statute, which is our best evidence of the legislative intent, clearly requires that the microlending activities be self-sufficient. It does require that the MBDC host organization is able to demonstrate that it has sufficient operating income to sustain the program.*

However, microlending is generally not a financially self-sufficient activity on its own. The local microloan programs are dependent upon the support of the host organization. The interest rate spread on their loans is approximately 9 percent. The administrative costs of operating the program (which does not include the bad debt expense) average \$49,772 for the nine MBDCs listed on Table 4. The average interest and fee income per MBDC is \$49,788. For the smallest MBDC, the administrative costs may be more difficult to manage.

The \$6 to \$1 leverage provided by the program magnifies the risk of loan losses. The Microbusiness Advisory Council has recommended additional development loan funds and structural changes to the program that are designed to create a permanent source of funding to create a funded loan loss reserve. The funded loan loss reserve will not only provide a source of funds to help the local MBDCs replenish their revolving loan funds when they write off a loan, but it will also provide additional security to protect the State of Montana development loan funds.

Table 4 presents a misleading picture of the costs of operating the program. This was the first year that the MBDCs were required to report an allowance for loan losses. For many MBDCs, this meant that they had to create an allowance account when they previously had no account. The bad debt expense of \$342,798 should probably be reported mostly as a prior period adjustment. For example the bad debt expenses reported for Kalispell and Helena were entirely the result of previous years cumulative lending activity.

Conclusion #5:

*The Department also believes there have been weaknesses in some of the local MBDCs lending procedures. There are some MBDCs that have very good lending practices, and we encourage them to share their best practices with their peers. Since the structure of the program provides for local control and local lending decisions, the Department has only limited control over the local loan officers.*

Recommendation #1:

*The Department agrees that the Legislature should determine the future of the program. The legislature created the program in 1991, and should be proud of the accomplishments including the prestigious Presidential Award for Excellence in Public Support of Microenterprise Development. This award recognized the substantial contribution the Legislature, the Department, and the MBDCs have made over the past ten years to advance not only Montana's microbusinesses, but to advance the capacity of the industry on a national level. Many other state and local programs have looked to our program as a leader, innovator, and example of large-scale success in microlending. When the program was created, we were the first. Now, we have a mature program and we know our strengths and weaknesses.*

*The Department would like the 2001 Legislature to improve the program, helping to resolve the challenges we face to help the local MBDCs with the cost of loan losses and ensuring the protection of the \$5 million in Development Loans already invested in the program. With the \$6.5 million we had hoped for when we received the second appropriation in 1995, and the additional funds we plan to leverage, we can continue to use the program as one of our economic development tools.*

Recommendation #2:

*The Department generally concurs with this recommendation. The audit report is essentially requesting that the Department exert more control over local programs on a regular basis in many areas. The Department feels that the Legislature intended the program to be primarily a locally managed program responsive to local needs and control. We have already provided financial assistance to send seven MBDC loan officers to one of the highest rated RLF training programs offered. We intend to provide a total of \$10,000 for MBDC staff training in FY 2001, and we have requested \$10,000 per year in spending authority from the Legislature during the next biennium for training.*

*The Department would like more flexibility in requiring that MBDC loan officers receive on-going training. We have some MBDC loan officers that have been with their programs for years that have received adequate training. Other MBDC loan officers*

*have been hired with extensive banking experience. We also know that turnover in loan officers is a reality and we think training resources need to be devoted to those most in need of training. We are willing to consider including minimum education, experience, and continuing education requirements in our MBDC contracts as loan agreements are renewed. The main limiting factor for local MBDCs is the ability to pay for experienced and well-trained staff.*

Recommendation #3:

*The Department concurs with this recommendation.*

Recommendation #4:

*We concur with this recommendation and have already received copies of the current loan policies and procedures from all of the MBDCs.*

We intend to review those policies and assess whether they need revision. We hope to be able to use examples of best practices from some of our MBDCs to share with others. In addition, we will request assistance from national organizations that provide services to microloan organizations including CFED, NCCA, and the Association for Enterprise Opportunity. The MBDCs that have substandard policies will be required to adopt new policies and submit them to the Department for final approval.

Recommendation #5

*The Department concurs with this recommendation. The Department has collected information from MBDCs since the inception of the program. We have more information on the outcomes of the program than most RLF funders do. We have been trying to improve our collection of "impact" measures for the past year. A better system for tracking jobs created and retained and the level of success or failure of individual businesses over the terms of the loans would be beneficial.*

The Department feels that the Legislature intended the program to be primarily a locally managed program responsive to local needs and control. Many of the goals of the program are established by the local MBDCs. Some MBDC organizations have a mission of serving low-income individuals. Others are primarily economic development organizations. The Department feels that this flexibility is strength of the program and that the Legislature actually intended the program to be responsive to local needs. Therefore, each MBDC should establish local priorities and measure their progress towards achievement of their goals.